FORM 10-Q

FAIR ISAAC CORP - FIC

Exhibit:

Filed: February 08, 2006 (period: December 31, 2005)

Quarterly report which provides a continuing view of a company's financial position

PART I

PART I

PART II

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2005

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

[NO FEE REQUIRED]

For the transition period from_________ to _________

Commission File Number 0-16439

Fair Isaac Corporation

(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**94-1499887** *(I.R.S. Employer Identification No.)*
901 Marquette Avenue, Suite 3200 **Minneapolis, Minnesota** *(Address of principal executive offices)*	**55402-3232** *(Zip Code)*

Registrant's telephone number, including area code:
612-758-5200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer ☑ Accelerated Filer ☐ Non-Accelerated Filer☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☑ No

The number of shares of common stock outstanding on January 31, 2006 was 65,040,188 (excluding 23,816,595 shares held by the Company as treasury stock).

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PART I — FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

FAIR ISAAC CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value data)
(Unaudited)

	December 31, 2005	September 30, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 189,296	$ 82,880
Marketable securities available for sale, current portion	130,567	146,088
Receivables, net	156,403	156,375
Prepaid expenses and other current assets	17,452	20,249
Deferred income taxes	8,320	7,088
Total current assets	502,038	412,680
Marketable securities available for sale, less current portion	50,199	56,926
Other investments	2,161	2,161
Property and equipment, net	45,020	48,436
Goodwill	686,209	688,683
Intangible assets, net	107,867	114,623
Deferred income taxes	22,943	19,902
Other assets	6,597	7,650
	$ 1,423,034	$ 1,351,061
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 13,789	$ 11,579
Accrued compensation and employee benefits	33,897	31,373
Other accrued liabilities	44,167	39,368
Deferred revenue	56,087	55,837
Total current liabilities	147,940	138,157
Senior convertible notes	400,000	400,000
Other liabilities	5,577	7,810
Total liabilities	553,517	545,967
Stockholders' equity:		
Preferred stock ($0.01 par value; 1,000 shares authorized; none issued and outstanding)	—	—
Common stock ($0.01 par value; 200,000 shares authorized, 88,857 shares issued and 64,883 and 63,836 shares outstanding at December 31, 2005 and September 30, 2005, respectively)	649	638
Paid-in-capital	1,047,122	1,037,524
Treasury stock, at cost (23,974 and 25,021 shares at December 31, 2005 and September 30, 2005, respectively)	(747,104)	(775,746)
Unearned compensation	—	(1,284)
Retained earnings	573,612	546,450
Accumulated other comprehensive loss	(4,762)	(2,488)
Total stockholders' equity	869,517	805,094
	$ 1,423,034	$ 1,351,061

See accompanying notes to condensed consolidated financial statements.

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FAIR ISAAC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004
Revenues	$202,790	$195,546
Operating expenses:		
Cost of revenues (1)	67,045	69,770
Research and development	22,730	20,998
Selling, general and administrative (1)	63,383	53,568
Amortization of intangible assets (1)	6,263	6,784
Restructuring and acquisition-related	(674)	—
Total operating expenses	158,747	151,120
Operating income	44,043	44,426
Interest income	3,066	1,706
Interest expense	(2,135)	(2,033)
Other income (expense), net	(86)	657
Income before income taxes	44,888	44,756
Provision for income taxes	16,431	16,895
Net income	$ 28,457	$ 27,861
Earnings per share:		
Basic	$ 0.44	$ 0.41
Diluted	$ 0.43	$ 0.36
Shares used in computing earnings per share:		
Basic	64,211	68,570
Diluted	66,219	80,056

(1) Cost of revenues and selling, general and administrative expenses exclude the amortization of intangible assets. See Note 2 to the accompanying condensed consolidated financial statements.

See accompanying notes to condensed consolidated financial statements.

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FAIR ISAAC CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Common Stock Shares	Common Stock Par Value	Paid-In-Capital	Treasury Stock	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity	Comprehensive Income
Balance at September 30, 2005	63,836	$ 638	$1,037,524	$(775,746)	$ (1,284)	$546,450	$ (2,488)	$ 805,094	
Share-based compensation			9,514	—	—	—	—	9,514	
Exercise of stock options	1,183	12	(5,279)	36,808	—	—	—	31,541	
Tax benefit from exercised stock options	—	—	6,633	—	—	—	—	6,633	
Reclassification due to the adoption of SFAS No. 123(R)	—	—	(1,284)	—	1,284	—	—	—	
Forfeitures of restricted stock	(2)	—	51	(51)	—	—	—	—	
Repurchases of common stock	(283)	(3)	—	(12,763)	—	—	—	(12,766)	
Issuance of ESPP shares from treasury	149	2	(37)	4,648	—	—	—	4,613	
Dividends paid	—	—	—	—	—	(1,295)	—	(1,295)	
Net income	—	—	—	—	—	28,457	—	28,457	$ 28,457
Unrealized gains on investments	—	—	—	—	—	—	5	5	5
Cumulative translation adjustments	—	—	—	—	—	—	(2,279)	(2,279)	(2,279)
Balance at December 31, 2005	64,883	$ 649	$1,047,122	$(747,104)	$ —	$573,612	$ (4,762)	$ 869,517	$ 26,183

See accompanying notes to condensed consolidated financial statements.

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FAIR ISAAC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004
Cash flows from operating activities:		
Net income	$ 28,457	$ 27,861
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,059	13,472
Share-based compensation	9,514	433
Loss on sales of marketable securities	—	2
Deferred income taxes	(3,041)	—
Tax benefit from exercised stock options	6,633	3,753
Excess tax benefits from share-based payment arrangements	(3,647)	—
Net amortization of premium on marketable securities	35	8
Provision for doubtful accounts	368	676
Changes in operating assets and liabilities, net of acquisition effects:		
Receivables	(810)	6,371
Prepaid expenses and other assets	3,508	114
Accounts payable	2,246	241
Accrued compensation and employee benefits	2,594	(1,994)
Other liabilities	2,272	7,381
Deferred revenue	556	21,592
Net cash provided by operating activities	60,744	79,910
Cash flows from investing activities:		
Purchases of property and equipment	(2,545)	(3,089)
Collections of note receivable from sale of product line	249	250
Cash paid for acquisition, net of cash acquired	—	(33,800)
Cash proceeds from disposition of London Bridge Phoenix Software, Inc.	—	23,000
Purchases of marketable securities	(33,273)	(30,503)
Proceeds from sales of marketable securities	18,740	18,851
Proceeds from maturities of marketable securities	37,120	23,949
Net cash provided by (used in) investing activities	20,291	(1,342)
Cash flows from financing activities:		
Proceeds from issuances of common stock under employee stock option and purchase plans	36,154	17,868
Dividends paid	(1,295)	(1,371)
Repurchases of common stock	(12,766)	(109,892)
Excess tax benefits from share-based payment arrangements	3,647	—
Net cash provided by (used in) financing activities	25,740	(93,395)
Effect of exchange rate changes on cash and cash equivalents	(359)	407
Increase (decrease) in cash and cash equivalents	106,416	(14,420)
Cash and cash equivalents, beginning of period	82,880	134,070
Cash and cash equivalents, end of period	$189,296	$ 119,650
Supplemental disclosures of cash flow information:		
Cash paid (received) for income taxes, net	$ 9,050	$ (335)

See accompanying notes to condensed consolidated financial statements.

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Nature of Business

Fair Isaac Corporation

Incorporated under the laws of the State of Delaware, Fair Isaac Corporation is a provider of analytic, software and data management products and services that enable businesses to automate and improve decisions. Fair Isaac Corporation provides a range of analytical solutions, credit scoring and credit account management products and services to banks, credit reporting agencies, credit card processing agencies, insurers, retailers, telecommunications providers, healthcare organizations and government agencies.

In these condensed consolidated financial statements, Fair Isaac Corporation is referred to as "we," "us," "our," and "Fair Isaac."

Principles of Consolidation and Basis of Presentation

We have prepared the accompanying unaudited interim condensed consolidated financial statements in accordance with the instructions to Form 10-Q and the standards of accounting measurement set forth in Accounting Principles Board ("APB") Opinion No. 28 and any amendments thereto adopted by the Financial Accounting Standards Board ("FASB"). Consequently, we have not necessarily included in this Form 10-Q all information and footnotes required for audited financial statements. In our opinion, the accompanying unaudited interim condensed consolidated financial statements in this Form 10-Q reflect all adjustments (consisting only of normal recurring adjustments, except as otherwise indicated) necessary for a fair presentation of our financial position and results of operations. These unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements and notes thereto presented in our 2005 Annual Report on Form 10-K. The interim financial information contained in this report is not necessarily indicative of the results to be expected for any other interim period or for the entire fiscal year.

The condensed consolidated financial statements include the accounts of Fair Isaac and its subsidiaries. All intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. These estimates and assumptions include, but are not limited to, assessing the following: the recoverability of accounts receivable, goodwill, intangible assets, software development costs and deferred tax assets; estimated losses associated with contingencies and litigation; the ability to estimate hours in connection with fixed-fee service contracts, the ability to estimate transactional-based revenues for which actual transaction volumes have not yet been received, the determination of whether fees are fixed or determinable and collection is probable or reasonably assured; and the development of assumptions for use in the Black-Scholes model that estimates the fair value of our share-based awards and assessing forfeiture rates of share-based awards.

Adoption of New Accounting Pronouncement

<u>*SFAS No. 123(R), Share-Based Payment*</u>

Prior to October 1, 2005, we accounted for our share-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*. We generally recorded no employee compensation expense for options granted prior to October 1, 2005 as options granted generally had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our 1999 Employee Stock Purchase Plan ("Purchase Plan") as the purchase price of the stock was not less than 85% of the lower of the fair market value of our common stock at the beginning of each offering period or at the end of each offering period. In accordance with SFAS No. 123, we disclosed our net income and earnings per share as if we had applied the fair value-based method in measuring compensation expense for our share-based incentive awards.

FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Effective October 1, 2005, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation expense that we recognize beginning on that date includes expense associated with the fair value of all awards granted on and after October 1, 2005, and expense for the unvested portion of previously granted awards outstanding on October 1, 2005. Results for prior periods have not been restated.

Prior to the adoption of SFAS No. 123(R), we presented all tax benefits for deductions resulting from the exercise of stock options as operating cash flows on our consolidated statement of cash flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits for tax deductions in excess of the compensation expense recorded for those options (excess tax benefits) to be classified as financing cash flows. Accordingly, the $3.6 million excess tax benefit that is classified as a financing cash inflow on the accompanying condensed consolidated statement of cash flows for the quarter ended December 31, 2005 would have been classified as an operating cash inflow if we had not adopted SFAS No. 123(R).

We maintain the 1992 Long-term Incentive Plan (the "1992 Plan") under which we may grant stock options, stock appreciation rights, restricted stock and common stock to officers, key employees and non-employee directors. Under the 1992 Plan, a number of shares equal to 4% of the number of shares of Fair Isaac common stock outstanding on the last day of the preceding fiscal year is added to the shares available under this plan each fiscal year, provided that the number of shares for grants of incentive stock options for the remaining term of this plan shall not exceed 5,062,500 shares. As of December 31, 2005, 887,383 shares remained available for grants under this plan. The 1992 Plan will terminate in February 2012. In November 2003, our Board of Directors approved the adoption of the 2003 Employment Inducement Award Plan (the "2003 Plan"). The 2003 Plan reserves 2,250,000 shares of common stock solely for the granting of inducement stock options and other awards, as defined, that meet the "employment inducement award" exception to the New York Stock Exchange's listing standards requiring shareholder approval of equity-based inducement incentive plans. Except for the employment inducement award criteria, awards under the 2003 Plan will be generally consistent with those made under our 1992 Plan. As of December 31, 2005, 1,357,441 shares remained available for grants under this plan. The 2003 Plan shall remain in effect until terminated by the Board of Directors. We also maintain individual stock option plans for certain of our executive officers and the chairman of the board. There are no shares available for future grants under these plans. Stock option awards granted during the quarter ended December 31, 2005 have a maximum term of seven years and vest ratably over four years. Stock option awards granted prior to October 1, 2005 typically have a maximum term of ten years and vest ratably over four years.

We assumed all outstanding stock options held by former employees and non-employee directors of HNC Software, Inc. ("HNC"), who as of our acquisition date, held unexpired and unexercised stock option grants under the various HNC stock option plans. As of December 31, 2005, 1,479,987 shares remained available for future grant under these option plans.

Under the Purchase Plan we are authorized to issue up to 5,062,500 shares of common stock to eligible employees. Employees may have up to 10% of their base salary withheld through payroll deductions to purchase Fair Isaac common stock during semi-annual offering periods. The purchase price of the stock is the lower of 85% of (i) the fair market value of the common stock on the enrollment date (the first day of the offering period), or (ii) the fair market value on the exercise date (the last day of each offering period). Offering period means approximately six-month periods commencing (a) on the first trading day on or after January 1 and terminating on the last trading day in the following June, and (b) on the first trading day on or after July 1 and terminating on the last trading day in the following December.

The following table summarizes the share-based compensation expense included in operating expense captions that we recorded within the accompanying condensed consolidated statements of income:

	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004
	(In thousands)	
Cost of revenues	$ 2,826	$ 111
Research and development	1,835	29
Selling, general and administrative	4,853	293
	$ 9,514	$ 433

We estimate the fair value of options granted using the Black-Scholes option valuation model. We estimate the volatility of our common stock at the date of grant based on a combination of the implied volatility of publicly traded options on our common stock and our historical volatility rate, consistent with SFAS No. 123(R) and Securities and Exchange Commission Staff Accounting

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Bulletin No. 107 ("SAB 107"). Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our assessment that implied volatility is more representative of future stock price trends than historical volatility. We estimate expected term consistent with the simplified method identified in SAB 107 for share-based awards granted during the quarter ended December 31, 2005. We elected to use the simplified method as we changed the contractual life for share-based awards from ten to seven years starting in the quarter ended December 31, 2005. The simplified method calculates the expected term as the average of the vesting and contractual terms of the award. Previously, we estimated expected term based on historical exercise patterns. The dividend yield assumption is based on historical dividend payouts. The risk-free interest rate assumption is based on observed interest rates appropriate for the term of our employee options. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. For options granted, we amortize the fair value on a straight-line basis over the vesting period of the options.

We used the following assumptions to estimate the fair value of share-based payment awards:

	Stock Options Quarter Ended		Employee Stock Purchase Plan Quarter Ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Average expected term (years)	4.75	4.00	0.50	0.50
Expected volatility	28%	52%	18%	25%
Risk-free interest rate (range)	4.2–4.5%	3.2%	3.2%	1.6%
Expected dividend yield	0.2%	0.2%	0.2%	0.2%

The following table shows summarizes option activity during the quarter ended December 31, 2005:

	Shares (In thousands)	Weighted-average Exercise Price	Weighted-average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding at October 1, 2005	13,815	$ 29.14		
Granted	2,457	44.18		
Exercised	(1,183)	26.66		
Forfeited	(282)	36.72		
Outstanding at December 31, 2005	14,807	31.69	6.82	$ 189,550
Options exercisable at December 31, 2005	6,603	26.00	5.63	$ 122,852

The weighted average fair value of options granted during the quarter ended December 31, 2005 was $14.03. The aggregate intrinsic value of options outstanding at December 31, 2005 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock for the 14.2 million shares that had exercise prices that were lower than the $44.17 market price of our common stock at December 31, 2005. The total intrinsic value of options exercised during the quarter ended December 31, 2005 was $23.0 million, determined as of the date of exercise.

At September 30, 2005 we had 40,219 non-vested restricted stock awards and at December 31, 2005 we had 37,763 non-vested restricted stock awards that had a weighted average grant date fair value of $20.40.

We recorded $9.3 million in share-based compensation expense for stock options and purchases under the Purchase Plan and $0.2 million in share-based compensation expense for restricted stock awards for the quarter ended December 31, 2005. The total tax benefit related to this share-based compensation expense was $3.4 million. As of December 31, 2005, there was $87.3 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under all equity compensation plans. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. We expect to recognize that cost over a weighted average period of 2.5 years.

We received $36.2 million in cash from option exercises and issuance of stock under the Purchase Plan for the quarter ended December 31, 2005. The actual tax benefit that we realized for the tax deductions from option exercises of the share-based payment arrangements totaled $6.9 million for that period.

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Due primarily to our ongoing program of repurchasing shares on the open market, at December 31, 2005, we had 24.0 million treasury shares. We satisfy option exercises from this pool of treasury shares.

The following table illustrates the effect on our net income and earnings per share for the quarter ended December 31, 2004 as if we had applied the fair value recognition provisions of SFAS No. 123(R) to share-based compensation using the Black-Scholes valuation model.

(In thousands, except per share data)	Quarter Ended December 31, 2004
Net income, as reported	$ 27,861
Add: Share-based employee compensation expense included in reported net income, net of tax	270
Deduct: Share-based employee compensation expense determined under fair value based method for all awards, net of tax	(6,422)
Proforma net income including share-based compensation	$ 21,709
Earnings per share, as reported:	
Basic	$ 0.41
Diluted	$ 0.36
Proforma earnings per share — including share-based compensation:	
Basic	$ 0.32
Diluted	$ 0.29

Reclassification

Certain amounts from prior periods have been reclassified to conform to the current period presentation. We concluded that it was appropriate to classify auction rate securities as marketable securities available for sale. Auction rate securities are variable-rate debt instruments with longer stated maturities whose interest rates are reset at predetermined short-term intervals through a dutch auction system. Previously, we classified such instruments as cash and cash equivalents. Accordingly, we have made a reclassification to the condensed consolidated statement of cash flows for the quarter ended December 31, 2004, to reflect the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents. Accordingly, in the condensed consolidated statement of cash flows for the quarter ended December 31, 2004, we have included an additional $21.0 million in purchases of marketable securities and an additional $9.3 million in proceeds from sales of marketable securities. This change in classification did not affect previously reported results of operations for any period.

2. Amortization of Intangible Assets

Amortization expense associated with our intangible assets, which has been reflected as a separate operating expense caption within the accompanying condensed consolidated statements of income, consisted of the following:

	Quarter Ended December 31, 2005	2004
	(In thousands)	
Cost of revenues	$ 3,714	$ 3,732
Selling, general and administrative	2,549	3,052
	$ 6,263	$ 6,784

Cost of revenues reflects our amortization of completed technology, and selling, general and administrative expenses reflects our amortization of other intangible assets. Intangible assets were $107.9 million and $114.6 million, net of accumulated amortization of $65.1 million and $58.9 million, as of December 31, 2005 and September 30, 2005, respectively.

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

3. Restructuring and Acquisition-Related Expenses

The following table summarizes our restructuring and acquisition-related accruals associated with our November 2004 Braun acquisition, fiscal 2004 London Bridge acquisition, and certain other Fair Isaac facility closures. The current portion and non-current portion is recorded in other accrued current liabilities and other long-term liabilities within the accompanying condensed consolidated balance sheets.

	Accrual at September 30, 2005	Cash Payments	Reversals	Accrual at December 31, 2005
		(In thousands)		
Facilities charges	$ 6,361	$ (522)	$ (164)	$ 5,675
Less: current portion	(3,721)			(5,211)
Non-current	$ 2,640			$ 464

During the quarter ended December 31, 2005, we recorded a $0.7 million gain due to the sublease of office space that we had exited in fiscal 2002. The gain resulted from an adjustment to the liability established for the exit of the lease space and a refund received for past rent paid to the landlord.

4. Earnings Per Share

The following table reconciles the numerators and denominators of basic and diluted earnings per share ("EPS"):

	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004
	(In thousands, except per share data)	
Numerator for basic earnings per share — net income	$ 28,457	$ 27,861
Interest expense on senior convertible notes, net of tax	1	1,267
Numerator for diluted earnings per share	$ 28,458	$ 29,128
Denominator — shares:		
Basic weighted-average shares	64,211	68,570
Effect of dilutive securities	2,008	11,486
Diluted weighted-average shares	66,219	80,056
Earnings per share:		
Basic	$ 0.44	$ 0.41
Diluted	$ 0.43	$ 0.36

The computation of diluted EPS for the quarters ended December 31, 2005 and 2004, excludes options to purchase approximately 648,000 and 4,275,000 shares of common stock, respectively, because the options' exercise prices exceeded the average market price of our common stock in these periods and their inclusion would be antidilutive. Emerging Issues Task Force ("EITF") Issue No. 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings Per Share* requires us to consider all instruments with contingent conversion features that are based on the market price of our own stock in our diluted earnings per share calculation, regardless of whether the market price conversion triggers are then met. The computation for diluted EPS for the quarter ended December 31, 2004 includes approximately 9,101,000 shares of common stock issuable upon conversion of our 1.5% Senior Convertible Notes. Effective with the March 31, 2005 exchange of Senior Convertible Notes for New Senior Convertible Notes ("New Notes"), the dilutive effect of the New Notes is calculated using the treasury stock method.

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. Segment Information

We are organized into the following four reportable segments, to align with the internal management of our worldwide business operations based on product and service offerings:

- *Strategy Machine Solutions.* These are Enterprise Decision Management applications designed for specific processes such as marketing, account origination, customer account management, fraud and medical bill review. This segment also includes our myFICO solution for consumers.
- *Scoring Solutions.* These include our scoring services distributed through major credit reporting agencies, as well as services through which we provide our scores to lenders directly.
- *Professional Services.* This segment includes revenues from custom engagements, business solution and technical consulting services, systems integration services and data management services.
- *Analytic Software Tools.* This segment is composed of our business rules management, model development and strategy design software sold to businesses for their use in building their own Enterprise Decision Management applications.

Our Chief Executive Officer evaluates segment financial performance based on segment revenues and operating income. Segment operating expenses consist of direct and indirect costs principally related to personnel, facilities, consulting, travel, depreciation and amortization. Indirect costs are allocated to the segments generally based on relative segment revenues, fixed rates established by management based upon estimated expense contribution levels and other assumptions that management considers reasonable. Our Chief Executive Officer does not evaluate the financial performance of each segment based on its respective assets or capital expenditures; rather, depreciation and amortization amounts are allocated to the segments from their internal cost centers as described above.

In fiscal 2006, we changed how we measure operating income by segment to exclude share-based compensation as a result of the adoption of SFAS No. 123(R) on October 1, 2005. We have reclassified prior period segment operating income to reflect this change.

The following tables summarize segment information for the quarters ended December 31, 2005 and 2004:

	Quarter December 31, 2005				
	Strategy Machine Solutions	Scoring Solutions	Professional Services (In thousands)	Analytic Software Tools	Total
Revenues	$ 111,986	$ 46,156	$ 32,831	$ 11,817	$ 202,790
Operating expenses	(91,366)	(16,622)	(30,913)	(11,006)	(149,907)
Segment operating income	$ 20,620	$ 29,534	$ 1,918	$ 811	52,883
Unallocated share-based compensation expense					(9,514)
Unallocated restructuring and acquisition-related					674
Operating income					44,043
Unallocated interest and other expense					(2,221)
Unallocated interest income					3,066
Income before income taxes					$ 44,888
Depreciation and amortization	$ 7,909	$ 1,985	$ 1,389	$ 776	$ 12,059

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FAIR ISAAC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Quarter Ended December 31, 2004				
	Strategy Machine Solutions	Scoring Solutions	Professional Services	Analytic Software Tools	Total
			(In thousands)		
Revenues	$ 117,812	$ 39,424	$ 29,470	$ 8,840	$ 195,546
Operating expenses	(97,326)	(17,644)	(27,141)	(8,576)	(150,687)
Segment operating income	$ 20,486	$ 21,780	$ 2,329	$ 264	44,859
Unallocated share-based compensation expense					(433)
Operating income					44,426
Unallocated interest expense					(2,033)
Unallocated interest and other income, net					2,363
Income before income taxes					$ 44,756
Depreciation and amortization	$ 8,529	$ 2,650	$ 1,689	$ 604	$ 13,472

6. Income Taxes

Our effective tax rate was 36.6% and 37.7% during the quarters ended December 31, 2005 and 2004, respectively. The provision for income taxes during interim quarterly reporting periods is based on our estimates of the effective tax rates for the respective full fiscal year. The decline in the effective tax rate was primarily due to our inability last year to recognize a tax benefit on certain foreign losses.

7. Contingencies

We are in disputes with certain customers regarding amounts owed in connection with the sale of several of our products and services. We also have had claims asserted by former employees relating to compensation and other employment matters. We are also involved in various other claims and legal actions arising in the ordinary course of business. We believe that none of these aforementioned claims or actions will result in a material adverse impact to our consolidated results of operations, liquidity or financial condition. However, the amount or range of any potential liabilities associated with these claims and actions, if any, cannot be determined with certainty. Set forth below is additional detail concerning certain ongoing litigation.

Customer Claims

We are party to two separate lawsuits involving two different customers who have asserted that our performance under professional services contracts with such customers have caused them to incur damages. One customer's lawsuit is pending in the United States District Court for the Central District of California, and the other is pending as a counterclaim to a collection lawsuit that we commenced in the United States District Court for the Southern District of Texas. The customers in these matters have claimed damages in excess of $10 million. We believe that these claims are without merit and we intend to contest them vigorously. We also believe that the resolution of these claims will not result in a material adverse impact to our consolidated financial condition.

Putative Consumer Class Action Lawsuits

We are a defendant in a lawsuit captioned as Robbie Hillis v. Equifax Consumer Services, Inc. and Fair Isaac, Inc., which is pending in the U.S. District Court for the Northern District of Georgia. The plaintiff claims that the defendants have jointly sold the Score Power® credit score product in violation of certain procedural requirements under the Credit Repair Organizations Act ("CROA"), and in violation of the anti-fraud provisions of that statute. The plaintiff also claims that the defendants are "credit repair organizations" under CROA. The plaintiff is seeking certification of a class on behalf of all individuals who purchased products containing Score Power from the defendants in the five year period prior to the filing of the Complaint on November 14, 2004. The plaintiff is seeking unspecified damages, attorney's fees and costs. We believe that the claims in this lawsuit are without merit and we have denied any liability or wrongdoing and have denied that class certification is appropriate. We are vigorously contesting this matter. The plaintiff has brought a motion for class certification and a motion for summary judgment in his favor and against the

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FAIR ISAAC CORPORATION
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(Unaudited)

defendants. We have filed briefs in opposition to the plaintiff's motions. We believe that the resolution of this claim will not result in a material adverse impact to our consolidated financial condition.

We are a defendant in a lawsuit captioned as Christy Slack v. Fair Isaac Corporation and MyFICO Consumer Services, Inc., which is pending in the United States District Court for the Northern District of California. As in the Hillis matter, the plaintiff is claiming that the defendants violated certain procedural requirements of CROA, and violated the antifraud provisions of CROA, with respect to the sale of credit score products on our myFICO.com website. The plaintiff also claims that the defendants violated the California Credit Services Act (the "CSA") and were unjustly enriched. The plaintiff will seek certification of a class on behalf of all individuals who purchased credit score products from us on the myFICO.com website in the five year period prior to the filing of the Complaint on January 18, 2005. Plaintiff seeks unspecified damages, attorneys' fees and costs. We believe that the claims in this lawsuit are without merit and we have denied any liability or wrongdoing and have denied that class certification is appropriate. We are vigorously contesting this matter. On April 22, 2005, we brought a motion to dismiss the plaintiff's claims. On June 27, 2005, the Court granted our motion, in part, by dismissing certain of the plaintiff's claims under the CSA. Discovery is proceeding at this time. We believe that the resolution of this claim will not result in a material adverse impact to our consolidated financial condition.

Braun Consulting, Inc.

Braun (which we acquired in November 2004) was a defendant in a lawsuit filed on November 26, 2001, in the United States District Court for the Southern District of New York (Case No. 01 CV 10629) that alleges violations of federal securities laws in connection with Braun's initial public offering in August 1999. This lawsuit is among approximately 300 coordinated putative class actions against certain issuers, their officers and directors, and underwriters with respect to such issuers' initial public offerings. As successor in interest to Braun we have entered into a Stipulation and Agreement of Settlement, pursuant to a Memorandum of Understanding, along with most of the other defendant issuers in this coordinated litigation, whereby such issuers and their officers and directors will be dismissed with prejudice, subject to the satisfaction of certain conditions, including, among others, approval of the court. Under the terms of this agreement, we will not pay any amount of the settlement.

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Item 2. ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

FORWARD LOOKING STATEMENTS

Statements contained in this Report that are not statements of historical fact should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995(the "Act"). In addition, certain statements in our future filings with the Securities and Exchange Commission ("SEC"), in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenue, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other statements concerning future financial performance; (ii) statements of our plans and objectives by our management or Board of Directors, including those relating to products or services; (iii) statements of assumptions underlying such statements; (iv) statements regarding business relationships with vendors, customers or collaborators; and (v) statements regarding products, their characteristics, performance, sales potential or effect in the hands of customers. Words such as "believes," "anticipates," "expects," "intends," "targeted," "should," "potential," "goals," "strategy," and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, those described in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations-Risk Factors, below. The performance of our business and our securities may be adversely affected by these factors and by other factors common to other businesses and investments, or to the general economy. Forward-looking statements are qualified by some or all of these risk factors. Therefore, you should consider these risk factors with caution and form your own critical and independent conclusions about the likely effect of these risk factors on our future performance. Such forward-looking statements speak only as of the date on which statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made to reflect the occurrence of unanticipated events or circumstances. Readers should carefully review the disclosures and the risk factors described in this and other documents we file from time to time with the SEC, including our reports on Forms 10-Q and 8-K to be filed by the Company in fiscal 2006.

RESULTS OF OPERATIONS

Overview

We are a leader in Enterprise Decision Management ("EDM") solutions that enable businesses to automate and improve their decisions. Our predictive modeling, decision analysis, intelligence management, decision management systems and consulting services power billions of customer decisions each year. We help companies acquire customers more efficiently, increase customer value, reduce fraud and credit losses, lower operating expenses and enter new markets more profitably. Most leading banks and credit card issuers rely on our solutions, as do many insurers, retailers, telecommunications providers, healthcare organizations and government agencies. We also serve consumers through online services that enable people to purchase and understand their FICO scores, the standard measure of credit risk, to manage their financial health.

Most of our revenues are derived from the sale of products and services within the consumer credit, financial services and insurance industries, and during the quarter ended December 31, 2005, 72% of our revenues were derived from within these industries. A significant portion of our remaining revenues is derived from the telecommunications, healthcare and retail industries, as well as the government sector. Our clients utilize our products and services to facilitate a variety of business processes, including customer marketing and acquisition, account origination, credit and underwriting risk management, fraud loss prevention and control, and client account and policyholder management. A significant portion of our revenues is derived from transactional or unit-based software license fees, annual license fees under long-term software license arrangements, transactional fees derived under scoring, network service or internal hosted software arrangements, and annual software maintenance fees. The recurrence of these revenues is, to a significant degree, dependent upon our clients' continued usage of our products and services in their business activities. The more significant activities underlying the use of our products in these areas include: credit and debit card usage or active account levels; lending acquisition, origination and customer management activity; workers' compensation and automobile medical injury insurance claims; and wireless and wireline calls and subscriber levels. Approximately 77% and 80% of our revenues during the quarters ended December 31, 2005 and 2004, respectively, were derived from arrangements with transactional or unit-based pricing. We also derive revenues from other sources which generally do not recur and include, but are not limited to, perpetual or time-based licenses with upfront payment terms, non-recurring professional service arrangements and gain-share arrangements where revenue is derived based on percentages of client revenue growth or cost reductions attributable to our products.

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Within a number of our sectors there has been a sizable amount of industry consolidation. In addition, many of our sectors are experiencing increased levels of competition. As a result of these factors, we believe that future revenues in particular sectors may decline. However, due to the long-term customer arrangements we have with many of our customers, the near term impact of these declines may be more limited in certain sectors.

One measure used by management as an indicator of our business performance is the volume of new bookings achieved. We define a "new booking" as estimated future contractual revenues, including agreements with perpetual, multi-year and annual terms. New bookings values may include: (i) estimates of variable fee components such as hours to be incurred under new professional services arrangements and customer account or transaction activity for agreements with transactional-based fee arrangements, (ii) additional or expanded business from renewals of contracts, and (iii) to a lesser extent, previous customers that have attrited and been re-sold only as a result of a significant sales effort. During the quarter ended December 31, 2005, we achieved new bookings of $127.8 million, including eight deals with bookings values of $3.0 million or more. In comparison, new bookings in the prior year quarter ended December 31, 2004 were $115.4 million, including seven deals with bookings values of $3.0 million or more.

Management regards the volume of new bookings achieved, among other factors, as an important indicator of future revenues, but they are not comparable to, nor should they be substituted for, an analysis of our revenues, and they are subject to a number of risks and uncertainties, including those described in Management's Discussion and Analysis of Financial Condition and Results of Operations – Risk Factors, below, concerning timing and contingencies affecting product delivery and performance. Although many of our contracts have fixed non-cancelable terms, some of our contracts are terminable by the client on short notice or without notice. Accordingly, we do not believe it is appropriate to characterize all of our new bookings as backlog that will generate future revenue.

Our revenues derived from clients outside the United States continue to grow, and may in the future grow more rapidly than our revenues from domestic clients. International revenues totaled $51.8 million and $49.4 million during the quarters ended December 31, 2005 and 2004, respectively, representing 26% and 25% of total consolidated revenues in each of these periods. In addition to clients acquired via our acquisitions, we believe that our international growth is a product of successful relationships with third parties that assist in international sales efforts and our own increased sales focus internationally, and we expect that the percentage of our revenues derived from international clients will increase in the future.

We acquired Braun Consulting, Inc. ("Braun") in November 2004 and certain assets of RulesPower, Inc ("RulesPower") in September 2005. Results of operations from these acquisitions are included prospectively from the date of acquisition. As a result, our financial results during the quarter ended December 31, 2005 are not directly comparable to those during the quarter ended December 31, 2004 or other quarters prior to any of these acquisitions.

Our reportable segments are: Strategy Machine Solutions, Scoring Solutions, Professional Services and Analytic Software Tools. Although we sell solutions and services into a large number of end user product and industry markets, our reportable business segments reflect the primary method in which management organizes and evaluates internal financial information to make operating decisions and assess performance. Comparative segment revenues, operating income, and related financial information for the quarters ended December 31, 2005 and 2004 are set forth in Note 5 to the accompanying condensed consolidated financial statements.

Revenues

The following tables set forth certain summary information on a segment basis related to our revenues for the fiscal periods indicated.

Segment	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004	Percentage of Revenues 2005	Percentage of Revenues 2004	Period-to-Period Change	Period-to-Period Percentage Change
	(In thousands)				(In thousands)	
Strategy Machine Solutions	$111,986	$117,812	55%	60%	$(5,826)	(5)%
Scoring Solutions	46,156	39,424	23%	20%	6,732	17%
Professional Services	32,831	29,470	16%	15%	3,361	11%
Analytic Software Tools	11,817	8,840	6%	5%	2,977	34%
	$202,790	$195,546	100%	100%	7,244	4%

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Quarter ended December 31, 2005 Compared to Quarter Ended December 31, 2004 Revenues

Strategy Machine Solutions segment revenues decreased due to a $7.1 million decrease in revenues from our *marketing solutions,* a $2.9 million decrease in revenues from our *insurance and healthcare solutions,* a $1.5 million decrease in revenues from our *originations solutions* and a $0.7 million net decrease in revenues from our other strategy machine solutions. The revenue decline was partially offset by a $2.7 million increase in revenues from our *consumer solutions,* a $2.5 million increase in revenues from our *collection and recovery solutions* and a $1.2 million increase in revenues from our *mortgage banking solutions*. The decrease in *marketing solutions* revenues was attributable primarily to the loss of two large financial services customers, which resulted from industry consolidation. The decrease in *insurance and healthcare solutions* revenues was attributable primarily to a decline in bill review volumes associated with our existing customer base, lower claims volumes at some of our key customers and loss of several customer accounts. The decrease in *originations solutions* revenues was the result of a decline in license sales. The increase in *consumer solutions* revenues was attributable primarily to increases in revenues derived from myFICO.com and our strategic alliance partners due to higher average selling prices and increased customer volumes. The increase in *collections and recovery solutions* revenues was attributable primarily to increases in license and maintenance revenues and volumes associated with transactional-based agreements. The increase in *mortgage banking solutions* revenues was attributable to increases in license and maintenance revenues.

Scoring Solutions segment revenues increased primarily due to an increase in revenues derived from risk scoring services at the credit reporting agencies, resulting from increased sales of scores for prescreening activities, and an increase in revenue derived from our own prescreening services.

During the quarters ended December 31, 2005 and 2004, revenues generated from our agreements with Equifax, TransUnion and Experian, collectively accounted for approximately 17% and 19%, respectively, of our total revenues, including revenues from these customers that are recorded in our other segments.

Professional Services segment revenues increased from industry consulting services and implementation services for our Blaze Advisor and collection and recovery products.

Analytic Software Tools segment revenues increased primarily due to an increase in sales of perpetual licenses of Blaze Advisor and Model Builder software applications and increased maintenance revenue.

Operating Expenses and Other Income (Expense)

The following table sets forth certain summary information related to our statements of income for the fiscal periods indicated.

	Quarter Ended December 31, 2005 (In thousands)	Quarter Ended December 31, 2004 (In thousands)	Percentage of Revenues 2005	Percentage of Revenues 2004	Period-to-Period Change (In thousands)	Period-to-Period Percentage Change
Revenues	$202,790	$195,546	100%	100%	$ 7,244	4%
Operating expenses:						
Cost of revenues	67,045	69,770	33%	36%	(2,725)	(4)%
Research and development	22,730	20,998	11%	11%	1,732	8%
Selling, general and administrative	63,383	53,568	31%	27%	9,815	18%
Amortization of intangible assets	6,263	6,784	3%	3%	(521)	(8)%
Restructuring and acquisition-related	(674)	—	—	—	674	—
Total operating expenses	158,747	151,120	78%	77%	7,627	5%
Operating income	44,043	44,426	22%	23%	(383)	(1)%
Interest income	3,066	1,706	1%	1%	1,360	80%
Interest expense	(2,135)	(2,033)	(1)%	(1)%	(102)	(5%)
Other income (expense), net	(86)	657	—	—	(743)	(113)%
Income before income taxes	44,888	44,756	22%	23%	132	—
Provision for income taxes	16,431	16,895	8%	9%	(464)	(3)%
Net income	$ 28,457	$ 27,861	14%	14%	596	2%
Number of employees at quarter end	2,864	2,929			(65)	(2)%

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Effective October 1, 2005, we adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment*, using the modified prospective transition method. Under this method, share-based compensation expense that we recognized for the quarter ended December 31, 2005 included expense associated with the fair value of all awards granted on and after October 1, 2005, and expense for the unvested portion of previously granted awards outstanding on October 1, 2005. The fair value of the unvested options outstanding as of October 1, 2005 was based on the fair value estimated on the grant date in accordance with the original provisions of SFAS No. 123. Results for prior periods have not been restated.

In accordance with SFAS No. 123(R), we recorded pre-tax share-based compensation expense of $9.5 million, or $0.09 per diluted share, during the quarter ended December 31, 2005. In comparison, we recorded share-based compensation expense of $0.4 million pre-tax during the quarter ended December 31, 2004. Share-based compensation expense was recorded in cost of revenues, research and development, and selling, general and administrative expense.

Cost of Revenues

Cost of revenues consists primarily of employee salaries and benefits for personnel directly involved in creating, installing and supporting revenue products; travel and related overhead costs; costs of computer service bureaus; internal network hosting costs; amounts payable to credit reporting agencies for scores; software costs; and expenses related to our consumer score services through myFICO.com.

The quarter over quarter decrease in cost of revenues resulted from a $2.9 million decrease in facilities and infrastructure costs and a $0.7 million decrease in third-party software and data. The decline was partially offset by a $0.9 million increase in personnel and other labor-related costs. The decrease in facilities and infrastructure costs was attributable primarily to a reduction in depreciation expense, lower outside costs for information systems and that the first quarter of fiscal 2005 included system integration costs associated with our acquisition of London Bridge. The decrease in third-party software and data costs was attributable primarily to a decline in insurance and healthcare solutions revenues and marketing services revenues. The increase in personnel and other labor-related costs was attributable primarily to a $2.7 million increase in share-based compensation expense due to the adoption of SFAS No. 123(R). The increase in personnel costs was partially offset by a reduction in salary costs.

Excluding the impact of SFAS No. 123(R), which requires expensing of all share-based awards, we expect that cost of revenues as a percentage of revenues in fiscal 2006 will be slightly lower than those incurred during fiscal 2005.

Research and Development

Research and development expenses include the personnel and related overhead costs incurred in development of new products and services, including primarily the research of mathematical and statistical models and the development of new versions of Strategy Machine Solutions and Analytic Software Tools.

The quarter over quarter increase in research and development expenditures was attributable primarily to an increase in research and development personnel and related costs of $1.4 million, primarily due to a $1.8 million increase in share-based compensation expense due to the adoption of SFAS No. 123(R). The increase in personnel costs was partially offset by lower salary costs.

Excluding the impact of SFAS No. 123(R), which requires expensing of all share-based awards, we expect that research and development expenditures as a percentage of revenues in fiscal 2006 will be consistent with those incurred during fiscal 2005.

Selling, General and Administrative

Selling, general and administrative expenses consist principally of employee salaries and benefits, travel, overhead, advertising and other promotional expenses, corporate facilities expenses, legal expenses, business development expenses, and the cost of operating computer systems.

The quarter over quarter increase in selling, general and administrative expenses was attributable to a $9.4 million increase in personnel and other labor-related costs and a $0.4 million net increase in other expenses. The increase in personnel and labor-related costs resulted primarily from a $4.6 million increase in share-based compensation expense due to the adoption of SFAS No. 123(R), higher payroll taxes due to employee stock option exercises and higher commission costs.

Excluding the impact of SFAS No. 123(R), which requires expensing of all share-based awards, we expect that selling, general and

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administrative expenses as a percentage of revenues in fiscal 2006 will be consistent with those incurred during fiscal 2005.

Amortization of Intangible Assets

Amortization of intangible assets consists of amortization expense related to intangible assets recorded in connection with acquisitions accounted for by the purchase method of accounting. Our definite-lived intangible assets, consisting primarily of completed technology and customer contracts and relationships, are being amortized using the straight-line method or based on forecasted cash flows associated with the assets over periods ranging from two to fifteen years.

The quarter over quarter decline in amortization expense was attributable to certain intangible assets becoming fully amortized prior to the current quarter and changes in foreign currency translation.

Restructuring and Acquisition-Related

During the quarter ended December 31, 2005, we recorded a $0.7 million gain due to the sublease of office space that we had exited in fiscal 2002. The gain resulted from an adjustment to the liability established for the exit of the lease space and a refund received for past rent paid to the landlord.

At December 31, 2005, accrued restructuring and acquisition related costs were $5.7 million, of which $5.2 million was classified as current.

Interest Income

Interest income is derived primarily from the investment of funds in excess of our immediate operating requirements. The quarter over quarter increase in interest income was attributable to higher interest and investment income yields due to market conditions and to a lesser extent higher average cash and investment balances. The increase in cash and investment balances resulted principally from cash provided by operating activities and proceeds received from the exercise of employee stock options.

Interest Expense

Interest expense recorded during the quarter ended December 31, 2005 relates to our $400.0 million of 1.5% Senior Convertible Notes ("Senior Notes"), including the amortization of debt issuance costs, and is consistent with the interest expense related to the Senior Notes recorded by us during the quarter ended December 31, 2004.

Other Income (Expense), Net

Other income, net consists primarily of realized investment gains/losses, exchange rate gains/losses resulting from re-measurement of foreign-denominated receivable and cash balances held by our U.S. reporting entities into the U.S. dollar functional currency at period-end market rates, net of the impact of offsetting forward exchange contracts, and other non-operating items.

The decline in other income (expense), net was primarily due to foreign exchange losses of $0.1 million that were recognized in the quarter ended December 31, 2005, compared with a net foreign currency gain of $0.4 million recorded in the quarter ended December 31, 2004.

Provision for Income Taxes

Our effective tax rate was 36.6% and 37.7% during the quarters ended December 31, 2005 and 2004, respectively. The provision for income taxes during interim quarterly reporting periods is based on our estimates of the effective tax rates for the respective full fiscal year. The decline in the effective tax rate was primarily due to our inability last year to recognize a tax benefit on certain foreign losses.

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Operating Income

The following table sets forth certain summary information on a segment basis related to our operating income for the fiscal periods indicated.

Segment	Quarter Ended December 31, 2005	Quarter Ended December 31, 2004	Period-to-Period Change	Period-to-Period Percentage Change
	(In thousands)			
Strategy Machine Solutions	$20,620	$20,486	$ 134	1%
Scoring Solutions	29,534	21,780	7,754	36%
Professional Services	1,918	2,329	(411)	(18)%
Analytic Software Tools	811	264	547	207%
Segment operating income	52,883	44,859	8,024	18%
Unallocated share-based compensation	(9,514)	(433)	(9,081)	—
Unallocated restructuring and acquisition-related	674	—	674	—
Operating income	$44,043	$44,426	(383)	(1)%

The quarter over quarter decrease in operating income was attributable primarily to increased share-based compensation expense due to the adoption of SFAS No. 123(R), partially offset by the impact of an increase in segment revenues. At the segment level, the increase in segment operating income was driven by increases of $7.8 million, $0.5 million and $0.1 million in segment operating income within our Scoring Solutions, Analytic Software Tools and Strategy Machine Solutions segments, respectively, partially offset by a $0.4 million decrease in segment operating income within our Professional Services segment. The increase in Scoring Solutions segment operating income was attributable primarily to an increase in revenues derived from risk scoring services at the credit reporting agencies, resulting from increased sales of scores for prescreening activities, and an increase in revenues derived from our own prescreening services. Operating income also increased due to lower infrastructure and personnel costs. We believe that operating income as a percentage of revenues in our Scoring Solutions segment may decline in the future due to lower operating margins on new products. In our Analytic Software Tools segment, higher segment operating income was due to an increase in sales of perpetual licenses for our EDM products, partially offset by increased product development and sales costs. The increase in Strategy Machine Solutions segment operating income was attributable to increases in sales of higher margin product offerings and a decline in personnel costs, partially offset by the impact of revenue declines we experienced in marketing solutions and insurance and healthcare solutions. The decrease in Professional Services segment operating income was the result of higher personnel and outside consultant costs.

Capital Resources and Liquidity

Cash Flows from Operating Activities

Our primary method for funding operations and growth has been through cash flows generated from operating activities. Net cash provided by operating activities decreased from $79.9 million during the quarter ended December 31, 2004 to $60.7 million during the quarter ended December 31, 2005. The decrease in operating cash flows was driven by a $19.0 million prepayment (net of revenue recognized) from a single customer for future services that we received in the first quarter of the prior year and the timing of income tax payments.

Cash Flows from Investing Activities

Net cash provided by investing activities totaled $20.3 million during the quarter ended December 31, 2005, compared to net cash used by investing activities of $1.3 million in quarter ended December 31, 2004. The change in cash flows from investing activities was attributable to a $10.3 million increase in proceeds from sales and maturities of marketable securities, net of purchases, during the first quarter of this year, $33.8 million in cash paid for acquisitions, due to our acquisition of Braun Consulting in November 2004, and $23.0 million in cash proceeds related to our disposition of London Bridge Phoenix Software, Inc., a subsidiary of London Bridge, in November 2004.

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Cash Flows from Financing Activities

Net cash provided by financing activities totaled $25.7 million in the quarter ended December 31, 2005, compared to net cash used in financing activities of $93.4 million in quarter ended December 31, 2004. The change in cash flows from financing activities was primarily due to a $97.1 million decrease in common stock repurchased and an $18.3 million increase in cash proceeds from common stock issued under employee stock option and purchase plans.

Repurchases of Common Stock

From time to time, we repurchase our common stock in the open market pursuant to programs approved by our Board of Directors. During the quarter ended December 31, 2005, we expended $12.8 million in connection with our repurchase of common stock under such programs. In August 2005, our Board of Directors approved a common stock repurchase program that allows us to purchase shares of our common stock up to an aggregate cost of $200.0 million. Through December 31, 2005, we had repurchased 976,700 shares of our common stock under this program for an aggregate cost of $41.3 million.

Dividends

During the quarter ended December 31, 2005, we paid a quarterly dividend of two cents per common share, which is representative of the eight cents per year dividend we have paid in recent years. Our dividend rate is set by the Board of Directors on a quarterly basis taking into account a variety of factors, including among others, our operating results and cash flows, general economic and industry conditions, our obligations, changes in applicable tax laws and other factors deemed relevant by the Board. Although we expect to continue to pay dividends at the current rate, our dividend rate is subject to change from time to time based on the Board's business judgment with respect to these and other relevant factors.

Credit Agreement

We are party to a credit agreement with a financial institution that provides for a $15.0 million revolving line of credit through February 2007. Under the agreement, as amended, we are required to comply with various financial covenants, which include but are not limited to, minimum levels of domestic liquidity, parameters for treasury stock repurchases, and merger and acquisition requirements. At our option, borrowings under this agreement bear interest at the rate of LIBOR plus 1.25% or at the financial institution's Prime Rate, payable monthly. The agreement also includes a letter of credit subfeature that allows us to issue commercial and standby letters of credit up to a maximum amount of $5.0 million and a foreign exchange facility that allows us to enter into contracts with the financial institution to purchase and sell certain currencies, subject to a maximum aggregate amount of $25.0 million and other specified limits. As of December 31, 2005, no borrowings were outstanding under this agreement and we were in compliance with all related covenants. As of December 31, 2005, this credit facility served to collateralize certain letters of credit aggregating $0.7 million, issued by us in the normal course of business. Available borrowings under this credit agreement are reduced by the principal amount of letters of credit and by 20% of the aggregate amount of contracts to purchase and sell certain foreign currencies outstanding under the facility.

Capital Resources and Liquidity Outlook

As of December 31, 2005, we had $370.1 million in cash, cash equivalents and marketable security investments. We believe that these balances, including interest to be earned thereon, and anticipated cash flows from operating activities, will be sufficient to fund our working and other capital requirements over the course of the next twelve months and for the foreseeable future. In the normal course of business, we evaluate the merits of acquiring technology or businesses, or establishing strategic relationships with or investing in these businesses. We may elect to use available cash and cash equivalents and marketable security investments to fund such activities in the future. In the event additional needs for cash arise, we may raise additional funds from a combination of sources, including the potential issuance of debt or equity securities. Additional financing might not be available on terms favorable to us, or at all. If adequate funds were not available or were not available on acceptable terms, our ability to take advantage of unanticipated opportunities or respond to competitive pressures could be limited.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

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Critical Accounting Policies and Estimates

We prepare our consolidated financial statements in conformity with U.S. generally accepted accounting principles. These accounting principles require management to make certain judgments and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. We periodically evaluate our estimates including those relating to revenue recognition, the allowance for doubtful accounts, goodwill and other intangible assets resulting from business acquisitions, internal-use software, income taxes and contingencies and litigation. We base our estimates on historical experience and various other assumptions that we believe to be reasonable based on the specific circumstances, the results of which form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our consolidated financial statements:

Revenue Recognition

Software license fee revenue is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred at our customer's location, the fee is fixed or determinable and collection is probable. We use the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and vendor-specific objective evidence of the fair value of all undelivered elements exists. Vendor-specific objective evidence of fair value is based on the normal pricing practices for those products and services when sold separately by us and customer renewal rates for post-contract customer support services. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of the fair value of one or more undelivered elements does not exist, the revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established. The determination of whether fees are fixed or determinable and collection is probable involves the use of assumptions. We evaluate contract terms and customer information to ensure that these criteria are met prior to our recognition of license fee revenue. We have not experienced significant variances between our assumptions and actual results in the past and anticipate that we will be able to continue to make reasonable assumptions in the future.

When software licenses are sold together with implementation or consulting services, license fees are recognized upon delivery provided that the above criteria are met, payment of the license fees is not dependent upon the performance of the services, and the services do not provide significant customization or modification of the software products and are not essential to the functionality of the software that was delivered. For arrangements with services that are essential to the functionality of the software, the license and related service revenues are recognized using contract accounting as described below.

If at the outset of an arrangement we determine that the arrangement fee is not fixed or determinable, revenue is deferred until the arrangement fee becomes due. If at the outset of an arrangement we determine that collectibility is not probable, revenue is deferred until the earlier of when collectibility becomes probable or the receipt of payment. If an arrangement provides for customer acceptance, revenue is not recognized until the earlier of receipt of customer acceptance or expiration of the acceptance period.

Revenues from post-contract customer support services, such as software maintenance, are recognized on a straight-line basis over the term of the support period. The majority of our software maintenance agreements provide technical support as well as unspecified software product upgrades and releases when and if made available by us during the term of the support period.

Revenues recognized from our credit scoring, data processing, data management and internet delivery services are recognized as these services are performed, provided persuasive evidence of an arrangement exists, fees are fixed or determinable, and collection is reasonably assured. The determination of certain of our credit scoring and data processing revenues requires the use of estimates, principally related to transaction volumes in instances where these volumes are reported to us by our clients on a monthly or quarterly basis in arrears. In these instances, we estimate transaction volumes based on preliminary customer transaction information, if available, or based on average actual reported volumes for an immediate trailing period. Differences between our estimates and actual final volumes reported are recorded in the period in which actual volumes are reported. We have not experienced significant variances between our estimates and actual reported volumes in the past and anticipate that we will be able to continue to make reasonable estimates in the future. If for some reason we were unable to reasonably estimate transaction volumes in the future, revenue may be deferred until actual customer data was received, and this could have a material impact on our results of operations during the period of time that we changed accounting methods.

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Transactional or unit-based license fees under software license arrangements, network service and internally-hosted software agreements are recognized as revenue based on system usage or when fees based on system usage exceed monthly minimum license fees, provided persuasive evidence of an arrangement exists, fees are fixed or determinable and collection is probable. The determination of certain of our transactional or unit-based license fee revenues requires the use of estimates, principally related to transaction usage or active account volumes in instances where this information is reported to us by our clients on a monthly or quarterly basis in arrears. In these instances, we estimate transaction volumes based on preliminary customer transaction information, if available, or based on average actual reported volumes for an immediate trailing period. Differences between our estimates and actual final volumes reported are recorded in the period in which actual volumes are reported. We have not experienced significant variances between our estimates and actual reported volumes in the past and anticipate that we will be able to continue to make reasonable estimates in the future. If for some reason we were unable to reasonably estimate customer account or transaction volumes in the future, revenue would be deferred until actual customer data was received, and this could have a material impact on our consolidated results of operations.

We provide consulting, training, model development and software integration services under both hourly-based time and materials and fixed-priced contracts. Revenues from these services are generally recognized as the services are performed. For fixed-price service contracts, we apply the percentage-of-completion method of contract accounting to determine progress towards completion, which requires the use of estimates. In such instances, management is required to estimate the input measures, generally based on hours incurred to date compared to total estimated hours of the project, with consideration also given to output measures, such as contract milestones, when applicable. Adjustments to estimates are made in the period in which the facts requiring such revisions become known and, accordingly, recognized revenues and profits are subject to revisions as the contract progresses to completion. Estimated losses, if any, are recorded in the period in which current estimates of total contract revenue and contract costs indicate a loss. If substantive uncertainty related to customer acceptance of services exists, we apply the completed contract method of accounting and defer the associated revenue until the contract is completed.

Revenue recognized under the percentage-of-completion method in excess of contract billings is recorded as an unbilled receivable. Such amounts are generally billable upon reaching certain performance milestones as defined by individual contracts. Billings collected in advance of performance and recognition of revenue under contracts are recorded as deferred revenue.

In certain of our non-software arrangements, we enter into contracts that include the delivery of a combination of two or more of our service offerings. Typically, such multiple element arrangements incorporate the design and development of data management tools or systems and an ongoing obligation to manage, host or otherwise run solutions for our customer. Such arrangements are divided into separate units of accounting provided that the delivered item has stand-alone value and there is objective and reliable evidence of the fair value of the undelivered items. The total arrangement fee is allocated to the undelivered elements based on their fair values and to the initial delivered elements using the residual method. Revenue is recognized separately, and in accordance with our revenue recognition policy, for each element.

As described above, sometimes our customer arrangements have multiple deliverables, including service elements. Generally, our multiple element arrangements fall within the scope of specific accounting standards that provide guidance regarding the separation of elements in multiple-deliverable arrangements and the allocation of consideration among those elements (e.g., American Institute of Certified Public Accountants Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, as amended). If not, we apply the separation provisions of Emerging Issues Task Force ("EITF") Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. The provisions of EITF Issue No. 00-21 require us to unbundle multiple element arrangements into separate units of accounting when the delivered element(s) has stand-alone value and fair value of the undelivered element(s) exists. When we are able to unbundle the arrangement into separate units of accounting, we apply one of the accounting policies described above to each unit. If we are unable to unbundle the arrangement into separate units of accounting, we apply one of the accounting policies described above to the entire arrangement. Sometimes this results in recognizing the entire arrangement fee when delivery of the last element in a multiple element arrangement occurs. For example, if the last undelivered element is a service, we recognize revenue for the entire arrangement fee as the service is performed, or if no pattern of performance is discernable, we recognize revenue on a straight-line basis over the term of the arrangement.

We record revenue on a net basis for those sales in which we have in substance acted as an agent or broker in the transaction.

Allowance for Doubtful Accounts

We make estimates regarding the collectibility of our accounts receivable. When we evaluate the adequacy of our allowance for doubtful accounts, we analyze specific accounts receivable balances, historical bad debts, customer creditworthiness, current economic trends and changes in our customer payment cycles. Material differences may result in the amount and timing of expense for

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any period if we were to make different judgments or utilize different estimates. If the financial condition of our customers deteriorates resulting in an impairment of their ability to make payments, additional allowances might be required. We have not experienced significant variances in the past between our estimated and actual doubtful accounts and anticipate that we will be able to continue to make reasonable estimates in the future. If for some reason we did not reasonably estimate the amount of our doubtful accounts in the future, it could have a material impact on our consolidated results of operations.

Business Acquisitions; Valuation of Goodwill and Other Intangible Assets

Our business acquisitions typically result in the recognition of goodwill and other intangible assets, and in certain cases non-recurring charges associated with the write-off of in-process research and development ("IPR&D"), which affect the amount of current and future period charges and amortization expense. Goodwill represents the excess of the purchase price over the fair value of net assets acquired, including identified intangible assets, in connection with our business combinations accounted for by the purchase method of accounting. We amortize our definite-lived intangible assets using the straight-line method or based on forecasted cash flows associated with the assets over the estimated useful lives, while IPR&D is recorded as a non-recurring charge on the acquisition date. Goodwill is not amortized, but rather is periodically assessed for impairment.

The determination of the value of these components of a business combination, as well as associated asset useful lives, requires management to make various estimates and assumptions. Critical estimates in valuing certain of the intangible assets include but are not limited to: future expected cash flows from product sales and services, maintenance agreements, consulting contracts, customer contracts, and acquired developed technologies and patents or trademarks; expected costs to develop the IPR&D into commercially viable products and estimating cash flows from the projects when completed; the acquired company's brand awareness and market position, as well as assumptions about the period of time the acquired products and services will continue to be used in our product portfolio; and discount rates. Management's estimates of fair value and useful lives are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. Unanticipated events and circumstances may occur and assumptions may change. Estimates using different assumptions could also produce significantly different results.

We continually review the events and circumstances related to our financial performance and economic environment for factors that would provide evidence of the impairment of our intangible assets. When impairment indicators are identified with respect to our previously recorded intangible assets, then we test for impairment using undiscounted cash flows. If such tests indicate impairment, then we measure the impairment as the difference between the carrying value of the asset and the fair value of the asset, which is measured using discounted cash flows. Significant management judgment is required in forecasting of future operating results, which are used in the preparation of the projected discounted cash flows and should different conditions prevail, material write downs of net intangible assets and other long-lived assets could occur. We periodically review the estimated remaining useful lives of our acquired intangible assets. A reduction in our estimate of remaining useful lives, if any, could result in increased amortization expense in future periods.

We test goodwill for impairment at the reporting unit level at least annually during the fourth quarter of each fiscal year and more frequently if impairment indicators are identified. We have determined that our reporting units are the same as our reportable segments. The first step of the goodwill impairment test is a comparison of the fair value of a reporting unit to its carrying value. We estimate the fair values of our reporting units using discounted cash flow valuation models and by comparing our reporting units to guideline publicly-traded companies. These methods require estimates of our future revenues, profits, capital expenditures, working capital, and other relevant factors, as well as selecting appropriate guideline publicly-traded companies for each reporting unit. We estimate these amounts by evaluating historical trends, current budgets, operating plans, industry data, and other relevant factors. The estimated fair value of each of our reporting units exceeded its respective carrying value in fiscal 2005, indicating the underlying goodwill of each reporting unit was not impaired as of our most recent testing date. Accordingly, we were not required to complete the second step of the goodwill impairment test. The timing and frequency of our goodwill impairment test is based on an ongoing assessment of events and circumstances that would more than likely reduce the fair value of a reporting unit below its carrying value. We will continue to monitor our goodwill balance and conduct formal tests on at least an annual basis or earlier when impairment indicators are present. There are various assumptions and estimates underlying the determination of an impairment loss, and estimates using different, but each reasonable, assumptions could produce significantly different results. Therefore, the timing and recognition of impairment losses by us in the future, if any, may be highly dependent upon our estimates and assumptions. We believe that the assumptions and estimates utilized were appropriate based on the information available to management.

Internal-use Software

Costs incurred to develop internal-use software during the application development stage are capitalized and reported at cost, subject to an impairment test as described below. Application development stage costs generally include costs associated with

internal-use software configuration, coding, installation and testing. Costs of significant upgrades and enhancements that result in additional functionality are also capitalized whereas costs incurred for maintenance and minor upgrades and enhancements are expensed as incurred. We assess potential impairment of capitalized internal-use software whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted net cash flows that are expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. This analysis requires us to estimate future net cash flows associated with the assets, as well as the future costs of selling such assets. If these estimates change, reductions or write-offs of internal-use software costs could result.

Share-Based Compensation

Prior to October 1, 2005, we accounted for our share-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Financial Accounting Standards Board ("FASB") SFAS No. 123, *Accounting for Stock-Based Compensation*. We generally recorded no employee compensation expense for options granted prior to October 1, 2005 as options granted generally had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our 1999 Employee Stock Purchase Plan as the purchase price of the stock was not less than 85% of the lower of the fair market value of our common stock at the beginning of each offering period or at the end of each offering period. In accordance with SFAS No. 123, we disclosed our net income and earnings per share as if we had applied the fair value-based method in measuring compensation expense for our share-based incentive awards.

Effective October 1, 2005, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment,* using the modified prospective transition method. Under that transition method, compensation expense that we recognize beginning on that date includes expense associated with the fair value of all awards granted on and after October 1, 2005, and expense for the unvested portion of previously granted awards outstanding on October 1, 2005. Results for prior periods have not been restated.

We estimate the fair value of options granted using the Black-Scholes option valuation model and the assumptions shown in Note 1 to the accompanying condensed consolidated financial statements. We estimate the volatility of our common stock at the date of grant based on a combination of the implied volatility of publicly traded options on our common stock and our historical volatility rate, consistent with SFAS No. 123(R) and Securities and Exchange Commission Staff Accounting Bulletin No. 107 ("SAB 107"). Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our assessment that implied volatility is more representative of future stock price trends than historical volatility. We estimate expected term consistent with the simplified method identified in SAB 107 for share-based awards granted during the quarter ended December 31, 2005. We elected to use the simplified method as we changed the contractual life for share-based awards from ten to seven years starting in the quarter ended December 31, 2005. The simplified method calculates the expected term as the average of the vesting and contractual terms of the award. Previously, we estimated expected term based on historical exercise patterns. The dividend yield assumption is based on historical dividend payouts. The risk-free interest rate assumption is based on observed interest rates appropriate for the term of our employee options. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. For options granted, we amortize the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods. If factors change we may decide to use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income and earnings per share.

Income Taxes

We use the asset and liability approach to account for income taxes. This methodology recognizes deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax base of assets and liabilities and operating loss and tax credit carryforwards. We then record a valuation allowance to reduce deferred tax assets to an amount that more likely than not will be realized. We consider future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, which requires the use of estimates. If we determine during any period that we could realize a larger net deferred tax asset than the recorded amount, we would adjust the deferred tax asset to increase income for the period or reduce goodwill if such deferred tax asset relates to an acquisition. Conversely, if we determine that we would be unable to realize a portion of our recorded deferred tax asset, we would adjust the deferred tax asset to record a charge to income for the period or increase goodwill if such deferred tax asset relates to an acquisition. Although we believe that our estimates

are reasonable, there is no assurance that our the valuation allowance will not need to be increased to cover additional deferred tax assets that may not be realizable, and such an increase could have a material adverse impact on our income tax provision and results of operations in the period in which such determination is made. In addition, the calculation of tax liabilities also involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could also have a material impact on our income tax provision and results of operations in the period in which such determination is made.

Contingencies and Litigation

We are subject to various proceedings, lawsuits and claims relating to products and services, technology, labor, shareholder and other matters. We are required to assess the likelihood of any adverse outcomes and the potential range of probable losses in these matters. If the potential loss is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. If the potential loss is considered less than probable or the amount cannot be reasonably estimated, disclosure of the matter is considered. The amount of loss accrual or disclosure, if any, is determined after analysis of each matter, and is subject to adjustment if warranted by new developments or revised strategies. Due to uncertainties related to these matters, accruals or disclosures are based on the best information available at the time. Significant judgment is required in both the assessment of likelihood and in the determination of a range of potential losses. Revisions in the estimates of the potential liabilities could have a material impact on our consolidated financial position or consolidated results of operations.

RISK FACTORS

Risks Related to Our Business

We derive a substantial portion of our revenues from a small number of products and services, and if the market does not continue to accept these products and services, our revenue will decline.

We expect that revenues derived from our scoring solutions, account management solutions, fraud solutions, originations, collections, and insurance solutions products and services will account for a substantial portion of our total revenues for the foreseeable future. Our revenues will decline if the market does not continue to accept these products and services. Factors that might affect the market acceptance of these products and services include the following:

- changes in the business analytics industry;
- technological change;
- our inability to obtain or use state fee schedule or claims data in our insurance products;
- saturation of market demand;
- loss of key customers;
- industry consolidation; and
- inability to successfully sell our products in new vertical markets.

If we do not engage in acquisition activity to the extent we have in the past, we may be unable to increase our revenues at historical growth rates.

Our historical revenue growth has been augmented by numerous acquisitions, and we anticipate that acquisitions will continue to be an important part of our revenue growth. Our future revenue growth rate may decline if we do not make acquisitions of similar size and at a comparable rate as in the past.

If we engage in acquisitions or significant investment in new businesses, we will incur a variety of risks, any of which may adversely affect our business.

We have made in the past, and may make in the future, acquisitions of, or significant investments in, businesses that offer complementary products, services and technologies. Any acquisitions or investments will be accompanied by the risks commonly encountered in acquisitions of businesses, which include:

- failure to achieve the financial and strategic goals for the acquired and combined business;
- overpayment for the acquired companies or assets;
- difficulty assimilating the operations and personnel of the acquired businesses;

- product liability exposure associated with acquired businesses or the sale of their products;
- disruption of our ongoing business;
- dilution of our existing stockholders and earnings per share;
- unanticipated liabilities, legal risks and costs;
- retention of key personnel;
- distraction of management from our ongoing business; and
- impairment of relationships with employees and customers as a result of integration of new management personnel.

These risks could harm our business, financial condition or results of operations, particularly if they occur in the context of a significant acquisition. Acquisitions of businesses having a significant presence outside the U.S. will increase our exposure to the risks of conducting operations in international markets.

We rely on relatively few customers, as well as our contracts with the three major credit reporting agencies, for a significant portion of our revenues. If the terms of these relationships change, our revenues and operating results could decline.

Most of our customers are relatively large enterprises, such as banks, insurance companies, healthcare firms, retailers and telecommunications carriers. As a result, many of our customers and potential customers are significantly larger than we are and may have sufficient bargaining power to demand reduced prices and favorable nonstandard terms. We also derive a substantial portion of our revenues and operating income from our contracts with the three major credit reporting agencies, TransUnion, Equifax and Experian, and other parties that distribute our products to certain markets. The loss of any major customer, the loss of a relationship with one of the major credit reporting agencies, the loss of a significant third-party distributor or the delay of significant revenue from these sources, could have a material adverse effect on our revenues and results of operations.

If we experience defects, failures and delays associated with the introduction of new products, our business could suffer serious harm.

Significant undetected errors or delays in new products or new versions of products may affect market acceptance of our products and could harm our business, financial condition or results of operations. In the past, we have experienced delays while developing and introducing new products and product enhancements, primarily due to difficulties developing models, acquiring data and adapting to particular operating environments. We have also experienced errors or "bugs" in our software products, despite testing prior to release of the products. Software errors in our products could affect the ability of our products to work with other hardware or software products, could delay the development or release of new products or new versions of products and could adversely affect market acceptance of our products. Errors or defects in our products that are significant, or are perceived to be significant, could result in the rejection of our products, damage to our reputation, lost revenues, diverted development resources, product liability claims and increased service and support costs and warranty claims.

We rely on relationships with third parties for marketing and distribution. If we experience difficulties in these relationships, our future revenues may be adversely affected.

Our Scoring Solutions segment and Strategy Machine Solutions segment rely on distributors, and we intend to continue to market and distribute our products through existing and future distributor relationships. Our Scoring Solutions segment relies on, among others, TransUnion, Equifax and Experian. Failure by our existing and future distributors to generate significant revenues, demands by such distributors to change the terms on which they offer our products, or our failure to establish additional distribution or sales and marketing alliances could have a material adverse effect on our business, operating results and financial condition. In addition, distributors may compete with us either by developing competitive products themselves or by distributing competitive offerings. For example, credit reporting agencies may evaluate and seek to distribute or acquire alternative vendors' prepaid products that compete with our products. Competition from distributors or other sales and marketing partners could significantly harm sales of our products.

The occurrence of certain negative events may cause fluctuations in our stock price.

The market price of our common stock may be volatile and could be subject to wide fluctuations due to a number of factors, including variations in our revenues and operating results. We believe that you should not rely on period-to-period comparisons of financial results as an indication of future performance. Because many of our operating expenses will not be affected by short-term fluctuations in revenue, short-term fluctuations in revenues may significantly impact operating results. Additional factors that will cause our stock price to fluctuate include the following:

- variability in demand from our existing customers;